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SUBJECT: GOI PROPOSED 2010 BUDGET: RIDING THE OIL ROLLER COASTER

¶1. (SBU) Summary: The GOI has proposed a 2010 budget to the Council of Representatives (CoR) that would increase expenditures by 22 percent. While security remains a budget priority, as do the essential services of oil and electricity, more resources are proposed for health, education, municipalities, water, and culture. Investment expenditures, key to long-term economic growth and job creation, are intended to increase a hefty 55 percent to account for 28 percent of the total budget, up from 22 percent last year. Higher prices and exports of oil are assumed to support these higher expenditures, but full budget implementation would still leave a deficit of 22 percent of GDP. Accumulated balances and domestic financing would only partially finance the deficit, leaving a gap to be filled by possible IMF and World Bank loans or, if the market continues to climb, higher oil prices. The Chair of the CoR Finance Committee hopes that the budget can be adopted by early December.

¶2. (SBU) This year's budget was the Minister of Finance's (MoF) first attempt to develop a medium-term budget framework and link policies to budget expenditures. The MoF also sought to hold spending steady, but rising oil prices, the prospect of signing major oil contracts, and electioneering conspired to raise planned expenditures. A modest spending plan that realistically could be implemented would allow for long-term planning and avoid the disruptive "on-again-off-again" cycle of spending that has characterized GOI budget implementation in the last two years. Given the pent-up demand and upcoming national elections, it seems that the GOI would prefer to push the spending envelope than follow the staid, practical approach of under promising but over delivering. They are riding the roller coaster of oil prices. End Summary.

PROPOSED 2010 BUDGET: EXPENDITURE BASICS

¶3. (SBU) The Council of Ministers (CoM) sent a proposed budget to the CoR in mid-October with total expenditures of USD 71.3 billion, revenues of USD 52.8 billion, and a resulting deficit of USD 18.5 billion. Expenditures are slated to increase 22 percent from 2009's budgeted levels, and revenues are expected to increase around 31 percent, largely based on an assumed oil price of USD 62.50/barrel and exports averaging 2.1 million barrels per day (mbpd).

¶4. (SBU) The proposed 2010 budget would increase the share of investment expenditures to 28 percent of total expenditures, up from 22 percent in 2009's budget, to total USD 19.7 billion. The GOI, encouraged by the International Monetary Fund, wanted to channel more resources to investment, which helps generate employment through projects and engenders long-term economic growth. About one-third of the increase in proposed capital expenditures is for electricity investment.

¶5. (SBU) Operational expenditures would rise 12 percent, with employee compensation declining as a share of the overall budget from 30.5 percent in 2009 to 27.6 percent. Last year, the government sought to cap employment, concerned that it would become a refuge for all unemployed. That policy seems to have been reversed this year with the proposed creation of 148,075 new positions that will be funded by the budget (45,291 in Ministry of Interior; 47,549 in Ministry of Defense). The draft budget law would authorize the Minister of Finance to create positions and

amend the work force to rehire politically dismissed employees, integrate former militia members, and receive transfers from self-funded companies. Wages and salaries increased only eight
Qself-funded companies. Wages and salaries increased only eight
percent, however, as 20 percent salary reductions are proposed for the highest executives (President of the CoR, President of the Republic, Prime Minister and their deputies) with 10 percent reductions for other senior officials (CoR members, Ministers, Under Secretaries and Directors General and equivalent staff).

PROPOSED 2010 BUDGET: REVENUE BASICS

¶6. (SBU) The story of the proposed 2010 budget revenue stream boils down to oil. True, oil has always accounted for the lion's share of revenues. The GOI, however, had previously sought to pump up non-oil revenues -- but not this year. While the government still stresses the need to increase non-oil revenues, such estimates for the 2010 budget are marked down 22 percent from 2009's budget to a more realistic USD 4.9 billion. Oil is expected to generate USD 47.9 billion or 91 percent of total revenue.

THE DEFICIT AND ITS FINANCING

¶7. (SBU) The MoF does not provide a precise indication of how the programmed deficit of USD 18.5 billion is to be financed other than to say it will use accumulated balances (which depends on 2009's budget execution and oil prices) and borrowing. However, the proposed budget authorizes the MoF to borrow USD 4.5 billion from the IMF and USD 2 billion from the World Bank and to use Iraq's Special Drawing Rights (USD 1.8 billion) from the IMF to help cover the deficit. This is a particularly important provision since it would signal to the IMF that the Parliament approves the IMF program conditions and the associated borrowing.

POLICY PRIORITIES

¶8. (SBU) According the proposed 2010 budget, GOI policy goals are to: (1) achieve security; (2) meet basic needs of citizens; (3) increase investment in human capital; (4) rebuild and construct new infrastructure; and (5) reduce unemployment. These policy priorities are confirmed by the numbers. Security budgets (MoI and MoD) account for 15.4 percent of total expenditures, still the highest single priority area, but down one percentage point from 2009's budgeted number. The oil sector accounts for 3.8 percent, unchanged from last year, and electricity five percent, up from two percent in 2009. The reason for the increase is to bring on the 2010 budget the payments already made this year of USD 2.4 billion to GE and Siemens that were not on 2009's budget. Expenditures on health, education, water, municipalities, environment, and youth, together up 38 percent, reflect investment in human capital and infrastructure that could contribute to job creation.

MEDIUM TERM STRATEGY

¶9. (SBU) An interesting development in building this year's budget was the first concerted attempt to create a medium-term budget strategy that linked expenditures to policy measures. With assistance from international donors, the MoF delivered a draft framework to the CoM in early June. The CoM then created a committee to review details with the Minister of Finance, and produced a report to guide 2010 budget preparation.

¶10. (SBU) The CoM committee made several recommendations that have been included in the proposed budget. These include:
(a) any increases in revenue be channeled to investment rather than operating expenditures;
(b) no automatic annual salary increases for officials at the DG level or higher rank;
(c) higher priority to health, education and culture during the next three years;
(d) Trade Ministry to produce a new plan to target the Public Distribution System to the truly needy (the budget provides for a reduction of expenditures for PDS by 16 percent to USD 3 billion);
(e) fees to be collected by the Ministries of Electricity,

Communications, Municipalities and Public Works for services rendered;
(f) eight companies to be dropped from the budget that are under the Ministry of Industry and Minerals and urge the Ministry to create economic partnerships or privatize the companies; and
(f) self-funding companies to fund any deficit spending with loans from Iraqi banks based on a business plan rather than the budget.

¶11. (SBU) Some of these issues emerged in the budget debate after ministries had discussed them in the context of preparing the Iraqi Poverty Reduction Strategy (PRS) sponsored by the World Bank. The PRS covers such issues as health, education, environment, and the social safety net, including the public distribution system. Many of these recommendations are in the proposed budget, but some would require supplementary legislation for implementation. Still, the effort to link policy to budget expenditures is an important step in budget preparation and planning.

PROCESS: COR AT WORK

¶12. (SBU) The Chair of the Finance Committee of the CoR would like to have the budget passed no later than December 15, by which time she suspects CoR members will return to their districts to campaign for the scheduled January national elections. She engineered the first budget bill reading on November 2 and has begun the serious work of analysis, building upon the experience in passing the 2009 budget law. The Chair also has established a mutually respectful Qworking relationship with the MoF, which has provided more information to the Committee at this stage of the budget process than in previous years. Organizing a CoR vote is not an easy task, but last year, many members deferred to the expertise of the Finance Committee on technical issues and did not engage in an extended political debate.

OBSERVATION: GOOD INTENTIONS AND THE PRICE OF A DEAL

¶13. (SBU) The MoF drafters of the 2010 proposed budget started out with good intentions. The initial medium-term budget strategy delivered to the CoM in early June was conservative, showing no increase in spending with revenue based on a USD 58/barrel price and exports of 2.15 million barrels a day, on average. The CoM expert group recommended increasing the price assumption to USD 60. When the MoF sent instructions to Ministries, they indicated that proposed spending for 2010 should not exceed that of 2009, but did not impose "hard" budget ceilings.

¶14. (SBU) Budget numbers starting spinning up in August when Ministries were negotiating with the MoF. Rather than respect nominal spending ceilings of the 2009 budget, Ministries stuck to

their usual practice of opening their request with a negotiating bid rather than a well-considered realistic request. In the event, the MoF received requests totaling USD 149 billion, more than twice the budget finally agreed within the CoM. Rising oil prices, the prospect of major oil contracts, and the elections also played a role in escalating expenditures. Oil revenues have increased steadily from May, when drafting began, to October, when the proposed budget was finalized. The Prime Minister began to pledge to pass benefits of higher oil prices to the people to meet basic needs.

¶15. (SBU) When the CoM agreed on a budget on October 13, total expenditures had risen to USD 67.3 billion. This was the level agreed to with the IMF earlier in the month. Some Ministries, however, were not pleased with their budgets. The Minister of Planning proposed reallocations based upon execution rates of the 2009 budget. When the Cabinet met on October 16 to consider the revised allocations, some members balked. Wanting to get the budget to the CoR for action this year and reach a final agreement with the IMF on a Stand By Arrangement, the Finance Minister offered the Ministries a deal. He offered to increase the budget by incorporating USD 4 billion of a proposed USD 5.7 billion 2009 supplemental budget and covering part of the increased expenditures by increasing the oil price assumption to average USD 62.50 and

exports to average 2.1 mbpd. He reportedly told the CoM that if they didn't agree to the new USD 71.3 billion in expenditures, he would stick with the USD 67.3 billion budget, as agreed with the IMF. The Cabinet acquiesced in this "take it or get less" stand. (Note: Accordingly, the MoF stated that as far it was concerned, the proposed supplemental budget is no longer on the table.) Thus, the budget deal was cut, but at an expenditure level nearly 22 percent higher from where the MoF started in May.

IMF ANGLE

¶16. (SBU) The IMF believed that the GOI faced a financing gap due to lower oil prices and therefore pressed the MoF to demonstrate budget discipline. As oil prices rose towards the end of the year, the financing gap would narrow if the higher prices held. The final USD 4 billion bump-up of the budget came as a surprise to the Fund. While the Minister was in Washington for the Business and Investment Conference, he had intense discussions with the Fund, which wanted some budget reductions. The Minister's response was that the budget had already been sent to the CoR, and moreover, reopening the budget with the Cabinet while oil prices were rising would lead to pressure for increasing expenditures, not reducing them. The Fund dropped its demand for budget reductions. The Fund and the MoF recognized that the oil prices could fall again, and tentatively have agreed that if the price of oil that Iraq receives is above an average of USD 73 dollars a barrel (to be calculated according to an IMF methodology) the SBA would become precautionary in 2010 rather than disbursing.

MORE OBSERVATIONS

¶17. (SBU) The MoF deserves credit for beginning a more serious medium-term budget strategy exercise and working hard to keep the timing of the budget process on track. The Minister is keen for a budget to be enacted this year, a view shared by the Chair of the Finance Committee. Failure to pass a budget before early December when parliamentarians start drifting away to campaign for the January national elections would mean no budget until a new government is formed, possibly as late as mid-year. By then, Qgovernment is formed, possibly as late as mid-year. By then, preparations for the 2011 budget will be underway. The GOI would still be able to allocate 1/12 of 2009's budget for expenditures each month per ministry, but would lose any benefits of the proposed increase spending. Moreover, failure to agree to a budget by early December would mean no agreement with the IMF, which needs to know budget details and the financing gap to be filled.

¶18. (SBU) While this year's budget process showed admirable improvements, it was also a missed opportunity. A more moderate budget that would be fully implemented would allow ministries to plan and execute strategically important programs and allow MoF to build up a reserve fund to buffer expenditures from oil price swings. Instead, the GOI is riding the roller coaster of oil prices: high expenditures in good times and low expenditures in bad. The Minister of Finance demonstrated his ability to rein in budget allocations in early 2009 when oil prices were well-below budgeted amounts. However, the "on-again-off-again" cycle of expenditures undermines the intention of policy makers when set national priorities through the budget.

HILL